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SUBJECT: UKRAINE "NOT YET THERE" ON 2009 BALANCED BUDGET

¶1. (SBU) Summary. The Ministry of Finance has granted a preview of the draft 2009 budget to the IMF and World Bank. The World Bank told us the GOU foresees a 2009 budget deficit equal to 0.3 percent of GDP. After studying the draft, however, the World Bank puts the deficit at 0.8 percent of GDP. In either case the draft does not foresee a balanced budget, a key conditionality of the IMF support program. The draft budget contains strong reductions in real wages and pensions, but also a drop in investment spending. In order to balance the budget, the World Bank has recommended further cuts in pensions, social privileges, and subsidies to coal producers and to entities in the energy sector, including Naftohaz. At the same time, it recommends increasing certain budgetary items that will help the population and economy deal with the fallout of the economic crisis. It is recommending that Ukraine heighten support payments for the country's most vulnerable citizens, and that it boost investment outlays as the best way to help the real economy. The USG, according to our interlocutor, can assist the IMF and World Bank by "raising the issue" of these recommendations with our Ukrainian counterparts. End summary.

GOU Budget Projections

¶2. (SBU) On December 6, Minister of Finance Viktor Pynzenyk invited the IMF and World Bank to review the government's draft budget for 2009. At his office on a Saturday afternoon, while his assistants compiled the budget's individual chapters, Pynzenyk explained that the government had made "hard decisions" on cuts in public sector wages, goods and services, capital spending, and pensions. The Minister claimed to have closed the deficit to less than 0.3 percent of GDP, with the ultimate goal of balancing the draft 2009 budget in the coming days, which currently constitutes roughly 43-44 percent of GDP.

¶3. (SBU) Pablo Saavedra, the World Bank's Kyiv-based chief economist, told us on December 9 that the Bank does not share the GOU's forecast. In the World Bank's view, the proposed budget still has a deficit of roughly 0.8 percent of GDP.

¶4. (SBU) Saavedra gave us an overview of the GOU draft. The Ministry's current plan is to keep nominal public sector wages at current levels. The action will cause real wages to drop significantly in real terms, saving 0.8 percent of GDP. The GOU is also planning significant reductions in public sector consumption. Stemming the rapid growth in pensions will pose the most difficult challenge to the GOU, he said. Parallel to the budget process, the Ministry has prepared a separate draft law that will cap increases in pensions in nine different ways. If passed, the caps would save another 1.8 percent of GDP in next year's budget, even if pensions remain poorly targeted once the law passes.

World Bank: More Cuts and Targeted Spending

¶5. (SBU) The World Bank and the Ukraine government are in line on 2009 revenue projections, with roughly $250 million separating their estimates. According to Saavedra, both the GOU and World Bank's conservative forecasts foresee revenues falling by 2 percent of GDP in 2009, due to industrial production declines, lower payroll tax collections from wage contraction and unemployment, and drops in revenue from import duties.

¶6. (SBU) Upon analyzing Pynzenyk's fiscal plan, the World Bank expressed to the Ministry that its spending cuts are admirable but "not there yet." To remove the difference between the GOU's and World Bank's forecasts for the budget deficit, the World Bank suggested better targeting of all social expenditures. It recommended chopping vestige Soviet-era privileges such as transportation fare reductions afforded to veterans, students, and the elderly. According to the World Bank, the greatest budget decreases can be made through cuts in subsidies to coal producers (saving 0.5 percent of GDP) and to the government energy monopoly Naftohaz and other entities in the energy sector, such as municipalities that are forced to sell heating below cost (saving 10 billion UAH or 1.8 percent of GDP).

¶7. (SBU) The World Bank said these cuts should be balanced by increases in targeted spending for Ukraine's poorest citizens. The government's most efficient social spending currently reaches 70 percent of the poorest families in the

country, aiding, for example, vulnerable large families and single mothers. Such under-funded programs should receive double or triple their current allotments, according to the World Bank, equivalent to roughly 0.4 percent of GDP.

¶8. (SBU) At the same time, the government should attempt to spur growth and employment by boosting the investment component of the budget, particularly by investing in crumbling infrastructure, Saavedra said. Increasing investment would be the best way for the budget to support the real economy, he argued. However, the GOU tends to think it can support the economy by giving special treatment to favored individual sectors, mostly through subsidies or tax breaks. The GOU has spent, on average, about 2 percent of yearly GDP on investment over the past four years, far lower than the 6 percent mark normally seen in more progressive transformational economies. Infrastructure development increases of 0.6 percent of GDP would improve transportation links and port capacity, simultaneously adding value and jobs to the overall economy, the World Bank believes.

Bank to Provide $1.2 Billion in Budget Support in 2009

¶9. (SBU) The World Bank intends to release the third $500 million tranche of its DPL3 loan to Ukraine by the end of December. It also plans to loan Ukraine up to $1.2 billion in budget financing in 2009. Of this, $750 million would be used for bank recapitalization and resolution, and only dispersed on a case by case basis as concrete needs arise. (Note: The IMF program considers outlays for bank reconstruction, bank resolution, and state-supported project finance programs to be exceptions to its overall balanced budget conditionality.)

World Bank and USG Collaboration

¶10. (SBU) Saavedra appealed for U.S. government support of the World Bank's budget proposals to the GOU. He emphasized that a U.S. push for transparent infrastructure investment could counter worsening conditions in the real economy, as

well as dash inefficient subsidies to favored or politically well-connected interests in the coal and energy sectors. Saavedra expressed enthusiasm for the Department of Treasury technical assistance team slated to visit Kyiv in mid-December, calling needs in the Ministry of Finance and the National Bank of Ukraine "critical."
TAYLOR